Global Imbalances and U.S. Policy Responses:

A Canadian Perspective

Richard G. Lipsey
and
Murray G. Smith

Canadian-American Committee

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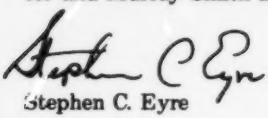

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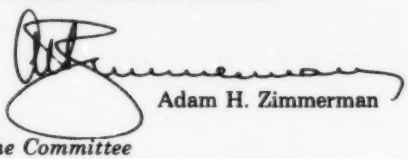

Adam H. Zimmerman

Co-chairmen of the Committee

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Foreword

Some of the issues in Canadian-U.S. economic relations arise from purely bilateral interactions; others arise from the policy response of either or both countries to global economic pressures. In its 1981 policy statement, *Improving Bilateral Consultation on Economic Issues*, the Canadian-American Committee noted:

> [P]ressing Canadian-American problems often stem directly from Canadian or American 'solutions', that is, from unilateral initiatives to meet some threat or exploit some opportunity. Being unilateral in inspiration as well as in execution, such moves by one country often bring inadvertent ill effects to the other.

The impulse for unilateral solutions has arisen on both sides of the 49th parallel. In the early 1980s, in response to the perception of a crisis in oil markets, Canada implemented energy and investment policies that caused an increase in bilateral tensions. Today, one source of bilateral tensions is the U.S. response to its perception of a crisis with respect to its trade deficit.

This study is derived from a paper, prepared by Richard G. Lipsey and Murray G. Smith of the C.D. Howe Institute, examining the implications of global imbalances for bilateral relations that was presented to the Committee at its meeting in Chicago in March 1987. The paper provoked considerable discussion, and although Committee members expressed a diversity of views about the merits of specific remedies, there was widespread agreement that the policy challenges arising from global trade and current account imbalances and the longer-term consequences of the rising international liabilities of the U.S. economy raised difficult questions for policymakers in both countries and could have important consequences for our interdependent economies.

Publication by the Committee does not imply that all of the members endorse the authors' specific points or conclusions. The Committee believes, however, that their analysis of the issues deserves wider consideration.

Stephen C. Eyre
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Richard G. Lipsey
Murray G. Smith
June 1987

1

The Current Problem in Perspective

Introduction

Global imbalances in trade and payments have increased sharply during the 1980s. In 1986, the United States had a trade deficit of U.S.$173 billion and a current account deficit that reached U.S.$140 billion, while Japan and West Germany ran trade surpluses of U.S.$82 billion and U.S.$112 billion respectively. Many developing countries remain mired in debt that constrains their economic prospects, limits their ability to trade with the developed countries, and threatens the stability of financial institutions. In the United States, the pressures of import competition and shrinking export markets have provoked a debate about competitiveness and stimulated proposals for "trade and competitiveness" legislation in Congress.[1]

The U.S. debate about the trade deficit and the appropriate policy response frequently has been cast in terms of moral opprobrium. Many Americans lay the blame for the trade deficit on what they perceive to be the "unfair" practices of the United States' trading partners. Herb Stein, of the American Enterprise Institute, has commented:

> Public attention seems to be shifting from the budget deficit to the trade deficit. Perhaps people think that the budget deficit is going away. More probably, they are bored with it because they have heard so much about it. The trade deficit is more satisfying to focus on. After six or seven years we don't know whom to blame for the budget deficit except ourselves. But we can, if we are not too careful about the facts, blame the trade deficit on foreigners.[2]

To many, the perceived unfair foreign trade practices call for changes to U.S. trade laws. The most controversial proposal, the Gephardt amendment, mandates retaliation unless countries that have bilateral trade surpluses with the United States and that are judged to be engaging in unfair

[1]The parameters of the U.S. debate are being set by the various legislative proposals. The House of Representatives has passed a bill, the *Trade and International Economic Policy Reform Act of 1987* (HR3), incorporating many of the provisions of HR4800 as passed by the House in the 99th Congress, which would extend the reach of U.S. fair trade laws substantially. In the Senate, another bill proposes to alter U.S. trade laws in a manner that is less restrictive on some issues and more restrictive on others. The administration's proposals, contained in the *Trade Employment and Productivity Act of 1987*, stress efforts to negotiate better access to export markets to improve education and training and to promote the development of U.S. technology, but it has received little consideration in Congress.

[2]H. Stein, "A Primer on the Other Deficit," *AEI Economist*, March 1987, p. 1.

trade practices reduce their trade surpluses by 10 percent a year. While such a proposal is unlikely to be part of the compromise trade bill that emerges from the process of negotiation among the House, the Senate, and the administration, what will emerge is almost certainly going to contain a complex array of changes to U.S. trade laws.

While these changes may put pressure on foreign governments to liberalize trade, the measures themselves often have the effect of restricting trade and in such cases are commonly called nontariff barriers to trade. Canada is the United States' largest trading partner, and its much smaller economy is heavily dependent on trade with the United States. Clearly, any unilateral U.S. actions that make major changes in the rules of its trade relations with other countries will have profound impacts on Canada.

Although the present turn toward protectionism in the United States is the most serious move in that direction since the 1930s, it has precedents in the recent past. In the late 1960s and early 1970s, the increasing overvaluation of the U.S. dollar led to balance of payments problems and created political pressures to restrict trade. Fred Bergsten, of the Washington-based Institute for International Economics, has characterized U.S. foreign economic policy as shifting among three prototypes: passive unilateralism, active unilateralism, and pluralistic cooperation. He states:

> These shifts in U.S. foreign economic policy have been much more pronounced regarding its monetary and macroeconomic components than its trade components. On trade, the United States has been fairly consistent in seeking to lead the way toward steady reduction of barriers and writing new rules — though, to be sure, with its own periodic protectionist deviations, and with occasional 'get tough' episodes designed largely to limit the extent of Congressional pressures for such deviations. These deviations in U.S. trade policy have occurred especially, as in 1969–72 and 1981–84, when the dollar became substantially overvalued and the trade balance deteriorated sharply — explaining...the sharp swings in American international macro/monetary policy.[3]

We agree with Bergsten's characterization of the link between U.S. trade imbalances on the one hand and the making of U.S. trade policy on the other — a link that gives rise to recurring cycles of protectionist pressures. Yet U.S. policymakers, perhaps recalling the effects of the Smoot-Hawley *Tariff Act of 1930*, have shied away from passing explicitly protectionist legislation that would impose tariffs or quotas on foreign goods. For example, Congress did not pass the Burke-Hartke bill in the early 1970s and it is unlikely to pass the Gephardt proposal in 1987. Instead, it has tended

[3]C.F. Bergsten, "America's Unilateralism," in C.F. Bergsten, E. Davignon, and I. Miyazaki, *Conditions for Partnership in International Economic Management*, Triangle Papers 32 (New York: Trilateral Commission, 1986), pp. 3–4.

to make U.S. import relief laws more responsive to domestic interests and, in particular, to strengthen the laws directed against unfair foreign trade practices. These changes have so far followed a ratchet principle; with rare and modest exceptions, the changes in the trade laws have all been in the direction of toughening them. Thus, postwar U.S. protectionist episodes have tended to make it progressively easier for domestic producers to obtain import relief in the form of duties or quotas imposed under trade laws.[4]

This study examines the debate on U.S. commercial policy from the point of view of the United States' largest trading partner. We argue that current and prospective U.S. policy decisions are reactions to events that are common knowledge but whose interpretations are open to debate.

Although we discuss the substantial risks to Canada from U.S. protectionism, our main focus is on the risks to the United States' own interests. Many Americans find the unilateral approach of attacking foreign trading practices to be attractive. It is not at all clear, however, that this approach will solve the current U.S. trade deficit problem. What it surely does is threaten to unravel the fabric of liberalized trade that the United States has helped to weave over the past 40 years. Moreover, it will return to haunt U.S. policymakers in the 1990s when the United States will be obliged to run a trade surplus in order to service its enormous international liabilities.

Unwinding the existing large trade and current account imbalances poses many challenges to policymakers in the United States and other countries. The policy choices made now will have important consequences for global economic relations and the future of the world economy, and will have particularly important implications for Canadian-U.S. relations.

Policymaking in Perspective

One thread that runs through much of this narrative is the tendency of policymakers to conclude that whatever persistent problems currently plague the world will continue to do so for all future time. When these problems turn out to be transitory, policies put in place to deal with them often persist and return later to haunt policymakers who are trying to deal with some new set of persistent problems. Policymakers are not alone in this. The late Harry Johnson often referred to the proclivity of economists to conclude that whatever persistent problems currently beset the world today would beset it for all future time. A review of a few of these "permanent problems" from the past may help us to gain perspective on the present problem.

In the 1920s, it was thought that the great bull market had brought permanent prosperity through continuing capital gains to all U.S. inves-

[4]See M.G. Smith, with C.M. Aho and G.N. Horlick, *Bridging the Gap: Trade Laws in the Canadian-U.S. Negotiations*, CAC 54 (Toronto; Washington, D.C.: Canadian-American Committee, 1987).

tors, large and small. Then came the Great Depression. A decade of severe recession in the 1930s was generalized into the theory of secular stagnation. Economists taught their students in all seriousness that never again would there be sufficient investment opportunities to mop up full employment savings.

The decade after the Second World War brought the dollar problem. Yet the ink was scarcely dry on Donald MacDougall's book,[5] in which he proved that the world's trading countries could never again sell enough to the United States to earn the dollars they needed, when the dollar shortage gave way to the dollar glut.

In the 1970s, inflation was the problem that was here to stay. Many economists argued that inflation might never be tamed without an apparatus of incomes policies that would severely threaten the workings of the price system. Or, if it could be tamed, a decade of prolonged depression would be required.[6] Breaking entrenched inflation proved costly and required a severe recession, but, by the standards of permanence, the high inflation of the 1970s proved remarkably transitory.

In the 1970s and early 1980s, many believed that the developed countries faced an ever-worsening energy crisis. Oil prices were expected to rise exponentially with little effect on energy demand or supply. It took several years, but rising prices did curtail demand and increase supplies. Today, all too many oil-producing countries continue to pay a heavy price for decisions taken in response to the assumed permanence of the oil boom.

Economists have been a little more guarded in generalizing about the high unemployment that has persisted since the 1970s. While it lasts, high unemployment is a serious problem requiring policy initiatives for its alleviation. But a permanent problem it is not. Indeed, most, but not all, of the theories of a permanent pool of unemployed labor have come from noneconomists. These theories finally will be carried away by the labor shortages of the late 1990s that existing demographic trends in the developed countries make all too predictable, unless there are some really massive and as yet unpredicted shifts on the demand side of the labor market.

Today, many in the United States are talking about a permanent U.S. balance of payments problem and a permanent loss of U.S. competitiveness. We see no reason to suspect that the trade deficit will be any more permanent than were previous persistent problems. The trade deficit problem and the arguments for its permanence may pass into oblivion and seem as quaint to future observers as does the theory of secular stagnation to us today.

This discussion, based as it is on analogy, is not conclusive with respect to current problems. But it surely provides a cautionary tale: those who

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[5]D. MacDougall, *The World Dollar Problem* (London: Macmillan, 1957).

[6]See, for example, J. Tobin, "Stabilization Policy Ten Years After," *Brookings Papers on Economic Activity* (1: 1980): 19–71.

propound theories of the permanence of current problems ignore the adjustment mechanisms that are at work; in so doing, these people confuse the slowness of adjustment with the absence of an adjustment mechanism.

Diagnosing persistent problems as permanent is not merely an innocuous human foible. Out of diagnoses come policy reactions — usually sold as "solutions" to the problem, although even their proponents recognize them to be imperfect responses. Because these solutions tend to outlive the problems that motivated them, there is a serious risk that they will prove to be counterproductive, or even disastrous, in the future. They may inhibit long-term adjustment processes when such processes do come into play, and they may aggravate tomorrow's problems when, sooner or later, they replace today's as the economy's "permanent" problems.

Our thesis is that the United States' response to its trade deficit represents a dramatic example of the tendencies discussed above. In the belief that permanent solutions are needed to solve a transitory, though serious, problem, U.S. policymakers are in danger of creating policy precedents that will seriously inhibit future U.S. policy initiatives.

World Trade Liberalization in the Past

To set today's events in historical perspective, let us cast our minds back to those dim and distant days of the Great Depression. Although foreign trade was then a small fraction of U.S. GNP, the United States was in the first rank of the world's traders, being second only to the United Kingdom as an exporter of manufactured goods. The United States was no different from most of the world's trading countries in having adopted beggar-thy-neighbor policies of trade restrictions in self-defeating attempts to export its unemployment to its trading partners. In 1922, the Fordney-McCumber act established record heights for U.S. tariffs, but these were exceeded by the Smoot-Hawley *Tariff Act of 1930*, which took U.S. tariffs to their high-water mark.

Many of the Roosevelt administration's domestic policies were interventionist. Yet its foreign economic policies were often quite liberal, in the classic nineteenth-century sense. Under the *Trade Act of 1934*, the administration was empowered to negotiate a series of bilateral, trade-liberalizing agreements. These agreements, negotiated with the United Kingdom, Canada, and many other U.S. trading partners on a "most favored nation" basis, were a precursor of the postwar General Agreement on Tariffs and Trade (GATT). Indeed, they accomplished a greater reduction of world tariffs than did the first several rounds of GATT negotiations.

These early initiatives were greatly reinforced after the Second World War when the United States backed the formation of the GATT, an organization designed to pave the way to a cooperative reduction of trade restrictions. The United States' leadership of the trade-liberalizing move-

ment proved decisive, and over the next three decades trade restrictions were reduced significantly, while world trade, and world prosperity, grew. Whatever the mixture of altruism and self-interest that lay behind this U.S. initiative, the world owes the United States much for its leadership in contributing to the forces of trade liberalization at a critical time in the early postwar era.

For foreigners to laud the United States for its leadership role in creating the GATT (as well as the International Monetary Fund and the World Bank) raises questions in the minds of some contemporary U.S. observers. They argue that while the United States has opened its markets through the GATT, other countries have not reciprocated to anything like the same extent. Some even suggest that the GATT has served the economic interests of other countries better than those of the United States.

Analyzing the economic benefits of the GATT to the United States is a speculative task because it involves predicting how world trade and trade relations would have evolved without the GATT. Some indication of the problems that might have arisen had the GATT not come into existence is given by the services and agricultural trade sectors, which the United States chose to leave outside of multilateral liberalizing arrangements.

At the very beginning of the GATT, in the late 1940s, the United States blocked the formation of the International Trade Organization (ITO), which would have provided some semblance of international rules regarding both investment policies and trade in services. Although they were not comprehensive at the time, the rules and procedures for handling services issues likely would have evolved over time if the ITO had come into existence. In the 1950s, the United States weakened the GATT rules applying to agricultural trade in an effort to preserve the autonomy of U.S. domestic farm policy. Today, U.S. (and Canadian) agriculture finds its export potential frustrated by the policies of the European Community and Japan, which were made permissible by the earlier U.S. action. Thus, in both cases, congressional solutions to problems of the 1940s and 1950s now serve to aggravate current problems.

Despite its deficiencies, the GATT system resulted in substantial liberalization of trade in the 35 years from 1947 to 1982 — due in large measure to U.S. leadership. Now, however, although it would be overly dramatic to say that the United States' liberal trade policy stance has changed completely during the 1980s, it would be unrealistic to pretend that some fundamental shifts have not occurred.

The Current Problem

The 1980s saw the most severe recession in 50 years. It was induced by restrictive monetary policies adopted to break the inflation that had become entrenched during the 1970s. The recession was experienced through-

Table 1
Fiscal Policy Indicator: Change in Structural Budget Balances, Selected Countries, 1982–87
(as a percentage of GNP)

	1982	1983	1984	1985	1986	1987
United States	−0.9	−0.7	−0.5	−0.8	−0.1	+0.9
Canada	−0.4	−1.7	−1.2	−0.6	+0.9	0.0
Japan	+0.3	+0.6	+1.2	+0.5	+0.3	+0.3
West Germany	+1.2	+1.3	+0.2	+0.6	−0.3	−0.3

Note: A plus (+) sign denotes a move toward surplus; a minus (−) sign denotes a move toward deficit.

Sources: *OECD Economic Outlook*, December 1985 and December 1986.

out the world, but the recovery has been nowhere near uniform. For several years, Europe remained mired in a slump that was exacerbated by restrictive fiscal policies, while the United States (and, with a lag, Canada as well) embarked on a vigorous recovery. The divergence in fiscal policy between the United States and Canada, which were pursuing expansionary policies, and Europe and Japan, which were not, is evident from Table 1.

In the course of this recovery, three important changes have occurred in U.S. economic relations with the rest of the world:

- the United States has become a sustained net importer of capital — indeed, by the beginning of 1985, it became a debtor country for the first time since 1914; by the end of 1985, it became the world's largest debtor country;
- the U.S. dollar rose to unprecedented heights on foreign exchange markets in 1985; it has since fallen dramatically; and
- a large deficit emerged on the U.S. merchandise trade account, which has proven difficult to reverse.

These developments clearly are interrelated and have been the subject of extensive commentary and analysis.[7] The next chapter examines alternative diagnoses of the causes of these developments and the implications of these diagnoses for the conduct of U.S. trade policy and for Canadian-U.S. economic relations.

[7]See, for example, C. F. Bergsten, "Economic Imbalances and World Politics"; and M. Feldstein, "Correcting the Trade Deficit," both in *Foreign Affairs* 65 (Spring 1987): 770–806.

2

Diagnoses and Prescriptions

There are three key, alternative views of the causes of the important changes that have taken place in the United States' recent economic relations with its trading partners. We call these diagnoses the *mainstream economists' view*, the *supply-side view*, and the *industrial policy school view*. Each diagnosis leads to very different policy prescriptions. The mainstream economists' view looks primarily to forces operating on the capital account of the balance of payments to explain the trade account deficit. The other two views look mainly to forces operating directly on the trade account to explain the trade account deficit, forces which operate to encourage U.S. imports while discouraging U.S. exports.

In this chapter, we look at each of these views in turn, and then at the views held by the U.S. administration and by members of Congress. A number of foreign factors have also had an influence, albeit a rather less important one, in creating the U.S. trade deficit. We address these foreign causes at the end of the chapter.

The Mainstream Economists' View

Diagnosis

The mainstream economists' explanation of the three events described at the end of Chapter 1 starts with macroeconomic relations and their influence on the balance of payments on capital account. This account has been in surplus in recent years, indicating large capital imports into the United States. Providing reasons for these capital imports is the first step in the explanation.

Capital Imports Explained

One reason arises from the relative attractiveness of the United States, during the 1980s, as a location for international investment funds. At home, a U.S. expansion stimulated partly by an expansionary domestic fiscal policy and partly by supply-side measures stimulated a surge in investment. At the same time, the continuing slump in Europe and the economic decline of some of the heavily indebted less-developed countries (LDCs) left the United States as the most attractive location for international investment. A change also took place in the underlying climate of opinion concerning safe locations for investment. The political stability of many LDCs, as they struggled to meet the International Monetary Fund's demands for aus-

terity, became a matter of genuine concern causing some flight of capital. Furthermore, a stagnant European economy, together with a growing body of interventionist red tape, seems to have convinced many investors of the longer-term unattractiveness, relative to the United States, of Western Europe as a place to invest.

Another reason for the U.S. capital imports is the large gap that has arisen between revenues and expenditures of governments — largely the federal government — in the United States, as is indicated in Table 1 (in Chapter 1). Tax cuts and rising defense expenditures, not fully matched by cuts in other expenditures, have added up to massive government budget deficits in recent years.

A third reason for the capital imports lies in the low U.S. savings rate. Although there is debate about the causes, there is no doubt about the phenomenon. The rate is low, both by the standards of other developed countries and, in the case of personal savings, by historical U.S. standards (see Table 2). Savings would have been barely adequate to finance private investment even in the absence of the massive public budget deficit.

The net effect of these macroeconomic forces, particularly the large budget deficit combined with low domestic savings, has been to induce a very large volume of U.S. net national *dissavings* — the sum of the government budget deficit and the shortfall of private savings below private investment.[1] U.S. net national dissavings first occurred in 1982. They increased to U.S.$112 billion by 1985 and were U.S.$100 billion in 1986. Thus, Americans have spent more on government purchases and transfers and on private-sector investment than has been available from domestic savings and government tax revenues, and the difference has had to be made up from foreign sources — in recent years, over U.S.$100 billion of foreign capital has had to be imported annually to cover that amount of net national dissavings. This transfer shows up in the balance of payments accounts as a surplus on capital account.

Obtaining the needed foreign capital flows has been made easier by the large volume of Japanese net national savings. But according to the mainstream view, the large U.S. net national dissavings would have entailed net foreign capital imports whatever the behavior of Japanese savings. The high Japanese savings rate has simply determined that the source of much of the capital imports has been Japan rather than some other country.

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[1] In symbols, net national savings or dissavings is $G + I - T - S$, where G is total government spending (including transfer payments), I is private investment spending, T is total tax revenue, and S is private savings. A positive total indicates net national savings, a negative total indicates dissavings. The latter worsens a country's foreign asset position because it increases the quantity of domestic assets that are held by foreigners and/or reduces the quantity of foreign assets that are held by domestic residents. Net national savings increase a country's foreign asset position because foreigners reduce their holdings of domestic assets and/or domestic residents increase their holdings of foreign assets.

Table 2
Savings, Investment, and External Current Account in Canada, the United States, and Japan, 1970–85
(as a percentage of GNP)

	Private savings			Private investment	Government balance	Net national dissavings	Current account balance
	Personal	Business	Total				
	(A)	(B)	(C)	(D)	(E)	(F=C−D+E)	(G)
Canada[a]							
1970	3.5	13.3	16.8	17.4	0.9	0.3	1.1
1975	7.3	12.6	19.9	20.3	−2.4	−2.8	−3.2
1980	8.5	14.8	23.3	20.5	−2.7	0.1	−0.7
1981	9.7	12.3	21.9	21.9	−1.6	−1.6	−2.1
1982	11.0	10.6	21.5	16.6	−5.0	−0.1	0.4
1983	9.3	13.8	23.1	16.6	−6.2	0.4	0.2
1984	9.3	14.2	23.5	16.2	−6.3	0.9	0.3
1985	8.3	13.6	21.9	16.8	−6.0	−0.9	−0.9
United States							
1970	5.6	10.4	16.0	14.5	−1.1	0.4	0.2
1975	6.1	12.2	18.2	13.3	−4.1	0.8	1.2
1980	4.2	12.4	16.5	15.3	−1.2	0.0	0.0
1981	4.6	12.6	17.2	16.4	−0.9	−0.1	0.2
1982	4.9	12.7	17.6	14.1	−3.5	0.0	−0.3
1983	3.6	13.6	17.4	14.7	−3.8	−1.1	−1.4
1984	4.5	13.4	17.9	17.6	−2.7	−2.4	−2.8
1985	3.6	13.6	17.2	16.5	−3.4	−2.7	−2.9
Japan[b]							
1970	11.5	22.0	33.1	33.9	1.8	1.0	1.0
1975	16.1	13.0	28.6	26.0	−2.7	−0.1	−0.1
1980	13.8	15.5	28.7	25.2	−4.4	−0.9	−1.0
1981	14.0	14.9	28.2	23.8	−3.8	0.6	0.4
1982	12.5	15.4	27.3	23.0	−3.6	0.6	0.6
1983	12.8	15.2	26.4	21.1	−3.7	1.6	1.8
1984	12.5	15.9	26.1	20.9	−2.2	3.0	2.8
1985	n.a.	n.a.	n.a.	n.a.	−1.4	n.a.	3.7

[a]Statistical differences between net national dissavings and the current account balance reflect the residual error of estimate in the National Accounts.

[b]For Japan, the sum of gross business savings and personal savings exceeds total private savings because of statistical discrepancies.

Sources: United States, Executive Office of the President, *Economic Report of the President, 1985* (Washington, D.C.: U.S. Government Printing Office, 1985), pp. 232, 262, 321; *Federal Reserve Bulletin*, May 1985, p. A53; International Monetary Fund, *International Financial Statistics Yearbook 1984* (Washington, D.C., 1984), pp. 363-65, 595; Organisation for Economic Co-operation and Development, *Quarterly National Accounts*, 1984, p. 36; Statistics Canada, *National Income and Expenditure Accounts*, Cat. no. 13-001, various issues; and United States, Department of Commerce, *Survey of Current Business* 66 (July 1986), pp. 26, 57, 58.

Trade Deficit

As is shown in more detail in Box 1, a capital account surplus must be matched by an equal and opposite current account deficit.[2] The common sense of this relationship is that if foreigners wish to buy U.S. dollars so as to buy U.S. assets and are unable to obtain the dollars by buying them from holders of U.S. dollars wanting to buy foreign assets (as they could if the capital account was in balance), they must obtain the dollars by buying them from holders of U.S. dollars wanting to buy foreign goods and services. Given the relative insensitivity of capital service items on the current account and the relatively small size of trade in services, the majority of the current account deficit must show up as a deficit on merchandise account.

Exchange Rate Appreciation

The mechanism that produced the trade account deficit is the exchange rate. The attractiveness of the United States as a place to invest led to a high demand for U.S. dollars, which bid up the price of the dollar on foreign exchange markets. In turn, this made U.S. exports less attractive on foreign markets and foreign imports more attractive on the U.S. market, thereby decreasing exports and increasing imports. The resulting trade deficit provided those people who wished to acquire U.S. capital assets with the surplus U.S. dollars they needed.

Conclusion

According to the mainstream view, the trade deficit originates mainly in the capital account. There are forces — such as export subsidies, concealed import restrictions, and other unfair trading practices on the part of foreign countries — that operate directly through the current account. Although these affect the *composition* of the trade account, they exert an influence on the current account *balance* that is minor relative to the influence of capital market forces.

To mainstream economists, the three events listed earlier are not unrelated, all being strongly influenced by U.S. macroeconomic policy in the 1980s. This policy package has combined monetary stringency with fiscal expansion at the same time that Europe and Japan have been implementing fiscal as well as monetary restraint. The expanding U.S. economy has sucked in the savings of other countries, and poor economic performance

[2]It is an irony of terminology that the mechanism producing these problems has worked through what is called a *favorable* shift in the terms of trade — U.S. prices have risen more than have foreign prices. When such shifts occur because foreign demand for U.S. products is rising rapidly, the outcomes can indeed be favorable to the United States; but when they occur because domestic costs are rising faster than foreign costs, the outcomes are likely to be unfavorable to the United States.

Box 1
Accounting for Savings-Investment Imbalances

This box summarizes the basic accounting relationships between savings and investment in the National Income accounts and between the capital and current accounts in the balance of payments.

I. *Net National Dissavings*

The production sector of the economy has the following components:

$$\text{Gross Domestic Product} = \text{Consumption} + \text{Government} + \text{Investment} + \text{Exports} - \text{Imports}$$

$$Y = C + G + I + X - M.$$

The conventional measure of gross national income is as follows:

$$\text{Gross National Product} = \text{Gross Domestic Product} + \text{Foreign Investment Income}$$

$$GNP = Y + F.$$

Note that F is a positive number for creditor countries and negative for debtors. Considering the uses of national income, we have:

$$\text{Gross National Income} = \text{Consumption} + \text{Taxes} + \text{Savings}$$

$$GNP = C + T + S$$

(where consumption is defined as expenditure on consumption goods, both imported and domestically produced, net of all indirect taxes).

Equating these two expressions yields:

$$C + G + I + X - M + F = C + T + S,$$

or

$$\underset{(1)}{(G - T)} + \underset{(2)}{(I - S)} = \underset{(3)}{(M - X)} - \underset{(4)}{F}.$$

(1) is the domestic budget deficit;
(2) is the difference between private-sector investment and savings;
(1) + (2) is net national dissavings;
(3) is the balance on traded goods and services;
(3) + (4) is the balance on current account.

II. *Capital and Current Accounts*

The value of dollars bought on the foreign exchange market, $B, must equal the value of dollars sold, $S:

$$\$B = \$S.$$

Ignoring the small amount of official settlements by central banks, dollars are bought to buy U.S. exports of goods and services, X, and for the repatriation of earnings on foreign capital invested in the United States, I_a, and for new investment flowing into the United States, K_a. Dollars are sold to buy foreign goods and services, M, to repatriate the income from U.S. capital invested abroad, I_a, and for new U.S. foreign investment, K_a. So,

$$X + I_a + K_a = M + I_a + K_a$$

or

$$(K_a - K_a) = (M - X) + (I_a - I_a).$$

Assuming invisibles to be relatively unresponsive in the short term, the above equation shows that the trade deficit must fluctuate with the net capital flow. If there are to be net capital imports, $K_a > K_a$, there *must* be a trade deficit, $M > X$.

in Europe and in the LDCs has made foreign capital eager to respond to the pull.

Prescriptions

Insofar as the cause of the capital inflow — which is the cause of the U.S. trade deficit — is a response to an increase in the relative attractiveness of the United States as a place to invest, this is a perfectly healthy development. There is no problem, and no policy reaction is needed.

Insofar as the capital inflow is a response to differential savings rates, much of the cure will come with the passage of time. One important reason for the divergence in U.S. and Japanese savings rates in the 1980s is demographic differences: relatively more Japanese are middle aged, while relatively more Americans are in their twenties or thirties. The divergence in savings rates will narrow as the proportion of retired people rises in Japan and as North American baby boomers reach middle age.

Insofar as the capital inflow is caused by the U.S. government budget deficit, there is reason for serious concern. By borrowing abroad to finance net national dissavings, the United States is mortgaging its future. The solution is to remove the deficit, or at least to reduce it greatly. That is where the policy effort should go. Once the deficit is brought under control, the stage will be set for the dollar to move toward a stable, sustainable rate and for the trade deficit to diminish, or to disappear altogether.

Whether the trade deficit is merely diminished or goes away completely will depend on the relative attractiveness of alternative national locations for international investment and the conduct of macroeconomic policy in the major developed countries. The United States might remain a prime location for foreign investors and might continue to be a net importer of capital, although on a much diminished scale. It might also return to the role it has played for most of this century: that of being a net exporter of capital. Either way, the current volume of net capital imports will diminish, and the existing foreign-held debt and equity will need to be serviced.

At that point, the prospects for U.S. economic growth will depend on the expansion of world trade. Furthermore, the servicing of foreign capital in the United States eventually will require a trade surplus. (This point is elaborated on in Box 2.) U.S. self-interest will then call for a liberal trading regime. If, in the meantime, the United States has encouraged the erection of high trade barriers and elaborate import regulatory regimes, it will be difficult for the U.S. export sector to revive sufficiently. The United States then might find itself in the position in which many large debtor countries now find themselves: hard pressed to service large amounts of foreign capital because export markets needed to generate the required trade surplus increasingly are being restricted by trade barriers.

The mainstream economists' view is that the U.S. trade deficit is transi-

Box 2
Servicing International Liabilities: U.S. Prospects

The change in the international balance sheet of the U.S. economy has been dramatic during the 1980s and will lead to significant debt-servicing requirements in the 1990s. At the end of 1985, the net liabilities of the United States were U.S.$107 billion. These foreign liabilities increased in 1986 by an amount roughly equivalent to the current account deficit of U.S.$140 billion. Even with significant improvements in the nominal trade and current account balances, most projections suggest that the U.S. current account deficit will average in excess of U.S.$100 billion through 1990. Thus, a reasonable estimate of U.S. international indebtedness would be between U.S.$700 and $900 billion by 1990 and could easily reach U.S.$1 trillion.

The significance of this external debt can be better appreciated by comparing it to total economic activity in the United States. Assuming that nominal GNP grows about 5 percent per year on average, U.S. GNP will be U.S.$5.1 trillion in 1990. The book value of U.S. foreign liabilities will be between 15 and 20 percent of U.S. GNP by 1990 and could continue to rise thereafter. By comparison, U.S. net foreign assets of U.S.$122 billion in 1980 represented about 5 percent of GNP in that year.

The cost of servicing these international liabilities will be influenced by the level of interest rates and by the composition of U.S. assets and liabilities among equities and short- and long-term debt. The U.S. net international debt and equity-servicing costs — investment income of foreigners — will probably fall within the range of U.S.$50 to $100 billion by the early 1990s. Thus, even if the U.S. economy were to continue to run a current account deficit in that range, the merchandise and traded services accounts will need to be roughly in balance by 1991. Achieving a balance on current account will require a substantial surplus on U.S. trade in goods and services in the 1990s because of the need to service foreign liabilities.

tory and will of necessity disappear — more quickly and with less pain if the budget deficit is reduced substantially, less quickly and with more difficulty, but just as surely, if the budget and current account deficits persist at, or near, their present levels. When the trade deficit problem has passed, U.S. self-interest once more will point firmly in the direction it did in the mid-1930s and again after 1945: toward trade liberalization. U.S. economists who accept this mainstream view should be strong in their hostility to today's growing protectionism while pressing for a drastic reduction of the domestic budget deficit. But the views of economists may not be widely shared.

The Supply-Side View

Translated into blood, sweat, and tears in the production trenches, the trade deficit means falling employment and rising bankruptcies in the export and import-competing sectors of U.S. manufacturing.[3] Not surprisingly, employees and employers in these affected sectors are extremely upset — and rightly so. Not surprisingly, the political arm is responsive to this concern — and rightly so. Not surprisingly, in searching for the cause of the intense competition that is killing U.S. firms and U.S. jobs, most people in the trenches look abroad — and wrongly so, according to mainstream economists.

The search for foreign causes of the deficit has been encouraged by some of the more evangelical versions of supply-side economics. Some observers refuse to see the high U.S. dollar as anything other than a manifestation of the strength of the U.S. economy and the weakness of the rest of the world. How, then, to account for the U.S. trade deficit? Given this view of the dollar, these observers have little left to blame but unfair trade practices by the rest of the world.

Diagnosis

So, the view of the people in the trenches has received support from some supply-siders. The high U.S. dollar reveals the strength of the United States. If Americans are having difficulties exporting to foreign markets and competing against imports in the domestic market, the fault must lie abroad; therefore, it must lie with unfair foreign competition. Foreign subsidies on exports and concealed restrictions on imports are hurting the U.S. tradable goods sector by unfairly encouraging U.S. imports and unfairly discouraging U.S. exports.

Prescriptions

Since the extreme supply-side view downplays the connection between the budget deficit and the strength of the U.S. dollar, the supply-siders' response to trade problems has been to attack perceived unfair foreign trade practices. The methods have been to tighten the application of unfair trade laws unilaterally and, despite a rhetorical commitment to free trade, to resort to *ad hoc* protection in the form of voluntary export restraints on such products as autos and steel. In addition, supply-siders have attacked foreign capital market restrictions, particularly in Japan, as creating unfair trade advantages for foreign producers.

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[3]The trade and balance of payments data do not use the divisions that are relevant today. The key distinction on the current account is not between visibles and invisibles, but between those items that react to changes in the exchange rate — traded goods *and* traded services — and those that do not — debt service items.

The Industrial Policy School View

A third view about the cause of the U.S. trade deficit is currently getting much attention. This is the view advocated by a group of economists who are members of what is often called the industrial policy school.[4] One of its important centers is the University of California at Berkeley; to the general public, the best-known member of this school is probably Lester Thurow of MIT.[5]

Diagnosis

Members of this school sometimes argue that the United States' current trading problems are due largely to fundamental changes in the microeconomic structure of the U.S. economy. The net effect of these changes, they argue, is a loss of U.S. competitiveness, which puts the United States in danger of following in the footsteps of the United Kingdom.

In assessing the ideas of this school, one must not lose sight of the key distinction between absolute and comparative costs. This distinction was introduced into economics in the early nineteenth century by David Ricardo; even today, it remains lesson one in any introduction to the analysis of international trade. If loss of competitiveness means that U.S. productivity grows at a slower rate than other countries' productivity, then U.S. living standards will decline (or, more likely, their rate of growth will decline). This may well be a matter of serious concern. It may well call for reactive policies. But it does not necessarily lead to a deficit in the balance of trade. International trade theory tells us that, in the long term, exchange rates adjust to compensate for absolute differences in productivity. Given exchange rates that can adjust freely to trade balances, the rates will settle at levels that allow low-productivity countries to trade profitably with high-productivity countries, without producing either persistent deficits or surpluses on the balance of payments. If exchange rates deviate from their trade-equilibrating levels because they are strongly influenced by capital movements, the problem lies with capital market factors and with government policies that influence capital markets, not with the absolute levels of productivity in current production.

While not denying the importance of capital account influences, some members of the industrial policy school see much of the United States' current trade deficit as resulting from a secular loss of competitiveness. This view has caught on; "loss of competitiveness" has become a buzzword in Washington, and many people are beginning to talk of permanent

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[4]For a more in-depth discussion of the views of this school, see R.G. Lipsey, "Report on the Symposium," in R.G. Lipsey and W. Dobson, eds., *Shaping Comparative Advantage*, Policy Study 2 (Toronto: C.D. Howe Institute, 1987).

[5]For an eloquent articulation of the industrial policy school view, see S. Cohen and J. Zysman, *Manufacturing Matters: The Myth of the Post-Industrial Economy* (New York: Basic Books for the Council on Foreign Relations, 1987).

productivity and growth gaps leading to balance of payments problems that will persist into the indefinite future. A permanent problem is perceived once again!

Prescriptions

By and large, members of the industrial policy school are not protectionists. But many of their policies are interventionist. In particular, they call for a coordinated industrial strategy that will direct activity toward sunrise industries, especially those with major spillover effects onto the rest of the economy.

Nonetheless, trade restriction implications can be drawn from the work of the industrial policy school. The main one comes from the school's view that many of today's high-technology, knowledge-based industries are footloose, in the sense that they do not derive locational advantages from the factor endowments that a country may possess. These industries are alleged, however, to be of particular advantage to a country. First, it is asserted that they have what are called spillover effects, which refers to their alleged effects in raising productivity and incomes in other related industries. Second, it is asserted that they yield positive, and sometimes large, pure profits, possibly for a long time.

The view that there are large profits waiting to be grabbed is one that receives some support from the new theories of industrial organization. The view that there are footloose industries whose location is not influenced by traditional considerations of comparative advantage derives from observing such newly industrializing countries (NICs) as Hong Kong and South Korea, although empirical analysis suggests that much of the observed shifts in trade flows can be explained by the traditional determinants of comparative advantage.[6]

The advice that follows from this industrial policy school view is to try to attract these footloose industries. The way to do this is by subsidizing their domestic development and protecting their domestic market until the "infants" grow up to be giants ready to conquer the world. The classic case here is the Japanese semiconductor industry, as studied by Paul Krugman.[7] In their haste to accept Krugman's findings of a case of an infant industry tariff that really worked — and worked to attract an industry that may have been footloose and that probably had major spillover effects — all too many policy advisors have neglected Krugman's second message: on a standard cost-benefit analysis, the whole operation appeared to have been a loser.

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[6]See E. Leamer, *Sources of International Comparative Advantage: Theory and Evidence* (Cambridge, Mass.: MIT Press, 1985); and Peter Morici, *The Global Competitive Struggle: Challenges to the United States and Canada*, CAC 50 (Washington, D.C.; Toronto: Canadian-American Committee, 1984).

[7]P. Krugman, ed., *Strategic Trade Policy and the New International Economics* (Cambridge, Mass: MIT Press, 1986).

More generally, members of the industrial policy school argue that an industrial policy is needed to restore U.S. competitiveness, possibly both by improving education and other key "background" factors and by picking, and backing, sunrise industries.

The Official View

We started with the mainstream economists' view, then went on to the supply-side and industrial policy school views but, so far, we have said nothing about official views.

Administration Views

The Reagan administration, at one time or another, has embraced all of the above views. Early in its life, many of the administration's vocal members, such as Donald Regan and Beryl Sprinkel of the Treasury Department, accepted the supply-side view. They saw the high U.S. dollar as nothing more than a manifestation of the underlying strength of the U.S. economy, and thus tended to see any trading difficulties as the fault of foreign governments.

Sometime in 1985, the administration's view regarding the exchange rate changed. It accepted the high U.S. dollar as a cause of the trade deficit and it made efforts, starting with the Plaza Agreement in September 1985, to induce a fall in the dollar's external value. This was a step forward. It remained unclear from public pronouncements, however, how much the administration attributed the high value of the dollar to net national dissavings.

In light of U.S. efforts to promote macroeconomic policy coordination since the Plaza Agreement, the administration's view seems to have come around to that of the mainstream economists. At least that is the position the president's Council of Economic Advisors took in 1987:

> The increase in the U.S. trade deficit is a macroeconomic phenomenon. Imports have grown strongly and exports have stagnated primarily because of the strong growth of the U.S. economy (especially in terms of demand growth) relative to other countries, the difficulties faced by many developing countries in managing their external debts, and the fall in U.S. price competitiveness associated with the large appreciation of the dollar between 1980 and early 1985. Underlying these developments are several macroeconomic imbalances, including the deterioration in the U.S. saving-investment balance that has resulted from the failure of the Federal Government to bring its expenditures in line with revenues.[8]

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[8]United States, Executive Office of the President, *Economic Report of the President, Transmitted to the Congress January 1987, together with the Annual Report of the Council of Economic Advisors* (Washington, D.C.: U.S. Government Printing Office, 1987), p. 97.

The administration also seems attracted to the industrial policy school view. Witness the substantial emphasis being put on competitiveness in speeches, by the president on down, urging a revival of the U.S. competitive spirit and the resurgence of its world-beating achievements. It is unclear, however, whether the administration is advocating the suspect view that an internal failure of U.S. competitiveness is responsible for the turnaround in the trade balance in the 1980s, or the more defensible view that there are longer-term trends in competitiveness that justify concern quite independently of the United States' current trade performance.

Congressional Views

Ironically, at about the time that the administration has moved closer to the mainstream economists' view of the cause of the trade deficit, some of the initiative on trade issues has shifted to Congress, which tends to reflect the view of people in the trenches.

Some groups in Congress are unabashedly protectionist, seeking the imposition of quotas and other restraints on foreign imports. Others are reluctant to support this type of legislation but, faced with pressures from constituents to act on import competition, have supported "free and fair trade", thereby lending their support to subtler forms of protectionism. The belief that the trade deficit is due to unfair foreign trading practices has contributed to a congressional consensus to use trade laws in a unilateral attempt to open foreign markets to U.S. exports and to restrict access to the domestic market for foreign imports that are perceived to be unfairly aided.

Since previous episodes of U.S. trade deficits have resulted in the broader application of U.S. trade laws, the result of this political compromise is a ratchet effect, whereby the trade laws are periodically toughened and seldom, if ever, weakened. It thus becomes easier and easier for U.S. producers to obtain import relief as time goes by.

By launching a fair trade offensive in September 1985, the administration tended to reinforce the views of those who believe the trade problem is caused by unfair foreign practices. Indeed, it is arguable that the administration's change of view on the exchange rate and the trade deficit has had much less influence than it otherwise might have had in restraining the forces of protectionism because the change was linked to the fair trade offensive.

Foreign Causes

Mainstream economists accept the existence of foreign influences that make it harder for U.S. firms to sell abroad and easier for foreign firms to sell in the United States — influences that would have been operating

without the upward push on the exchange rate caused by the capital inflow. They relegate those influences, however, to a role in creating the trade deficit that is secondary to macroeconomic forces. In the supply-side and industrial policy school views, a number of alleged foreign causes are given a prominent role.

Unfair Trade Practices

The European Community has resorted to some questionable trade practices, including subsidies to agriculture and to state-owned companies. The nature and extent of Japan's trade barriers are still subject to debate. Many of those who hold the supply-side and industrial policy school views point to hidden and subtle nontariff barriers, which are difficult to document, as examples of practices that are a major cause of the U.S. trade deficit.

The persistent bilateral trade imbalance between the United States and Japan is frequently cited as evidence of Japanese unfair trade practices. It is true that the United States ran a bilateral trade deficit with Japan prior to the expansion of the U.S. budget deficit after 1982. But prior to 1982, both the United States and Japan were in a position of approximate overall current account balance. The massive increases in the value of Japanese oil imports in the 1970s necessitated an equally massive surplus on other traded items, if oil was to be paid for on current account rather than with borrowed money. In 1982, Japan's deficit on oil account was U.S.$65 billion while its surplus on nonoil commodity items was U.S.$72 billion. If the United States had demanded a bilateral trade balance with Japan in 1982, it would have been forcing an enormous bilateral deficit on other countries so that Japan could finance its trade deficit in oil.

Since 1982, the deterioration in the U.S. trade balance in manufactured goods has occurred with most of its major trading partners, with neither Japan, nor the European Community, nor the Asian NICs having accounted for a disproportionate share of the deterioration, as is evident from Table 3.

Although accepting the existence, sometimes on a large scale, of unfair foreign trade practices, mainstream economists point out that the United States also indulges in some similar practices, so that the net effect of all of them taken together is difficult to gauge. More importantly, however, they also point out that most of these foreign practices have been in existence too long to account for the dramatic change in the U.S. trade balance that occurred between 1982 and 1985.

Undervalued Foreign Currencies

To a considerable extent, those who hold the supply-side and industrial policy school views realize the importance of the overvalued U.S. dollar. They have often looked, however, to foreign influences for the explanation,

Table 3
U.S. Trade in Manufactures, 1982 and 1985

Trading partner/area	Change in bilateral balances, 1982–85 (U.S.$ billions)	Percent share of U.S. imports		Percent share of U.S. exports	
		1982	1985	1982	1985
Canada	−4.6	20.1	18.8	19.8	26.2
Japan	−20.8	25.1	26.6	6.6	7.6
Western Europe	−21.1	26.0	26.1	26.7	26.7
Latin America	−10.4	6.1	6.2	12.2	12.9
East Asian NICs[a]	−16.4	14.6	15.0	7.0	7.2

[a]The newly industrializing countries of Hong Kong, Singapore, South Korea, and Taiwan.

Source: United States, Executive Office of the President, *Economic Report of the President, Transmitted to the Congress January 1987, together with the Annual Report of the Council of Economic Advisors* (Washington, D.C.: U.S. Government Printing Office, 1987).

seeing the problem as that of foreign governments' holding their currencies down rather that of the U.S. government's macroeconomic policies forcing the dollar up.

Because financial markets are highly integrated, it is difficult, in the absence of explicit government controls on international capital movements and foreign exchange transactions, for central banks to manipulate exchange rates through intervention in foreign exchange markets for any sustained period. In the case of the Canadian and U.S. financial markets, private capital flows dwarf transactions in the exchange market by the Bank of Canada or the Federal Reserve Board, leaving little scope for either of them to have significant sustained influence on the market. (They can, however, have short-term influence far beyond their own magnitudes when, by "nudging" the market one way or the other, they induce large flows of private capital.)

Nonetheless, influential U.S. senators have accused both Canada and Japan of holding down the value of their currencies on the foreign exchange market. The accusations against Canada, however, ignore the Bank of Canada's very evident attempts to stem the decline of the Canadian dollar from about U.S.$0.80–0.82 in 1979–80 to about U.S.$0.71–0.73 at the end of 1986.

In light of the concern that some U.S. policymakers have expressed about Canada's merchandise trade surplus with the United States and the perception of some congressmen that the Canadian dollar has been driven down as a matter of government policy to stimulate exports, it is worth noting the evidence on bilateral trade contained in Table 3. Although Canada is the United States' largest trading partner, the shift in U.S. trade in manufactures with Canada has been much less than with its other major trading partners. Canada's share of U.S. imports of manufactures declined about 1 percent from 1982 to 1985, while its share of U.S. exports of

manufactures increased from under 20 percent to over 26 percent during that period. Canada is the only major trading partner with which the United States has a bilateral surplus on trade in manufactures.

Capital Markets

If a country is willing to control capital flows, it can manipulate its exchange rate. No doubt some developing countries that have exchange controls do peg their currencies at artificially low exchange rates in order to stimulate exports and inhibit imports. Although the exchange rate policies of these countries may create some bilateral trade imbalances, they are not of sufficient magnitude to account for the enormous swing in the U.S. trade balance that has occurred in the 1980s. In any case, since none of the major developed countries imposes restrictions on capital flows or exchange rate transactions, they cannot manipulate their exchange rates in any sustained fashion.

One particular capital market development has had interesting consequences. Proponents of the industrial policy school and supply-side views concluded from low Japanese interest rates in the late 1970s and early 1980s that the regulation of Japanese capital markets was providing a subsidy to Japanese industrial producers. During the early 1980s, the United States pressed Japan to a liberalize its capital markets.

Although liberalizing capital markets can help prevent government manipulation of foreign exchange rates, it can be argued that, in Japan's case, liberalization also caused macroeconomic changes that worsened somewhat U.S. current account problems. When world interest rates rose in the 1980s, Japanese rates — instead of being insulated from world changes — rose as well, causing the investment share of Japan's GNP to contract from about 26 percent to 21 percent, as is evident from Table 2. This encouraged an outflow of Japanese capital to the United States, since the Japanese demand for funds was reduced by the rise in borrowing costs, while private savings remained high and public-sector borrowing contracted. On capital account, the high net national savings ratio that Japan has developed in the 1980s has entailed much foreign investment. Since the total world supply of savings seems unresponsive to interest rates, the consequences of the integration of the Japanese capital market has been to drive down world interest rates slightly and to lower the effective exchange rate of the yen until world demand for Japanese products expands sufficiently to take up the extra Japanese capital exports. As a result, the United States now imports more Japanese capital and runs a bigger trade deficit with Japan than it otherwise might.

Summary

To summarize briefly, mainstream economists attribute the U.S. trade deficit mainly to the stance of U.S. macroeconomic policy as well as to foreign fiscal restraint and related shifts in investment sentiment that occurred in the early 1980s, although foreign causes are granted a subsidiary role. The supply-side and industrial policy school views attach much more significance to alleged foreign causes of the trade deficit. The administration seems have to started off holding the supply-side view and then to have moved to a combination of the mainstream and industrial policy school views. Congress seems, at the moment, to be attracted mainly to the supply-side view.

3

Solutions

In this chapter, we survey the most seriously advocated solutions to the U.S. trade deficit. These solutions can be divided into four main proposals: depreciate the U.S. dollar, make changes to macroeconomic policy, make changes to trade policy, or make changes to industrial policy.

Depreciate the U.S. Dollar

When the Reagan administration abandoned its extreme supply-side view and came to accept that the U.S. trade deficit had something to do with the high value of the U.S. dollar, its first approach was to solve the problem by attacking its proximate cause, the high external value of the dollar, while promising to deal later with its underlying macroeconomic causes.

The first step in this direction was the commitment made by the so-called Group-of-Five (G-5) developed countries in autumn 1985 to lower the value of the U.S. dollar. When efforts were made to talk it down, the dollar did fall significantly against the yen and most European currencies. Of course, there were some underlying forces at work, not the least of which was that the U.S. structural budget deficit had stopped expanding, while the Japanese and West German structural budget deficits had stopped contracting. Nonetheless, the G-5's tough talk in September 1985 probably did help to burst an apparent speculative bubble.

The mainstream economists' view is that efforts to depreciate the dollar through intervention in exchange markets cannot do the job as long as macro imbalances persist. Nonetheless, the failure of the trade deficit to respond to a substantial depreciation of the dollar greatly strengthened congressional and public support for the view that unfair trade practices must be a major cause of that deficit.

It needs to be pointed out that economists are not surprised by either the magnitude or the persistence of the trade deficit. A recent research workshop involving analysis of several multicountry economic models has reported that all of the models accurately predicted the trade deficit through the second half of 1986.[1] It is worth detailing, however, some of the reasons why the nominal trade deficit so far has shown so little response to the dollar's depreciation.

First, the time required to adjust trade flows to changes in prices causes

[1] R. Bryant and G. Holtham, "The External Deficit: Why? Where Next? What Remedy?" *Brookings Review* 5 (Spring 1987): 28–36.

countries to show a lag of 12–18 months between a change in their exchange rates and a full adjustment in their trade balances. This lag is expressed empirically in what economists call the J curve. Particularly for a large economy such as the United States, exports tend to be priced in the domestic currency, while imports tend to be priced in foreign currencies. This accentuates the J-curve effect on both the import and the export side. The initial effect of a lower dollar is to increase the import bill. This is because foreign products priced in foreign currencies become more expensive in terms of dollars, while the quantity of imports contracts slowly. Exports priced in dollars become cheaper in terms of foreign currency but, since quantities take some time to react, export revenues remain static at first. Over two or three years, the more price-competitive U.S. exports will begin to regain foreign markets, but this process can be painfully slow. It takes time for U.S. producers to regain market share in domestic and export markets due to the improvement in price competitiveness with foreign products.

Second, the consequences of the exchange rate being overvalued for several years may not be easily reversed. In modern economies, where large investments in sunk capital — in terms of such things as plant and equipment or product development costs — are important, there is often room for only a few firms in an industry. If U.S. firms leave the market due to an overvalued exchange rate and are replaced by foreign firms, a return to the original exchange rate will not necessarily allow U.S. firms to reenter the market. Furthermore, when firms in one country lose a market and cease ongoing research and development, it may take years to rebuild their R&D capability and to regain the momentum that confers dynamic scale economies. These considerations suggest that the United States may discover to its sorrow the importance of avoiding even a few years of a perverse macropolicy in a world of irreversibilities, or at least major asymmetries of adjustment.

Third, special circumstances operated in 1985 and 1986 to reduce the effects of a given fall in the external value of the U.S. dollar below what they normally would be. Voluntary export restraints' for example, restricted much trade. As conventional analysis of supply and demand predicts, when quantity restrictions are operative, any rise in the foreign supply price of foreign imports due to depreciation of the dollar causes a decline in profit margins with no decline in sales (until prices rise so much that quantity constraints are no longer binding).

Fourth, the appreciation of the dollar during the 1982–85 period created a backlog of adjustments that were still in process when the dollar began to fall. If nothing else had changed, the trade deficit would have increased as old plants were not replaced and as costly shifts of existing facilities to other products or other markets were made. The fall in the dollar merely removed the incentive for some of these changes to occur

in the future while not reversing observed current behavior.

Fifth, many of the international macroeconomic factors that contributed to the trade deficit still persist. Weak economic growth in Europe and Japan has discouraged a reversal in their external accounts. Also, the developing countries' indebtedness inhibits their ability to purchase exports from the developed countries.

Sixth, it should be noted that since its peak in March 1985, the value of the dollar has depreciated unevenly against other currencies: about 50 percent against the yen and the deutschmark but not at all, or even appreciated, against the currencies of major U.S. trading partners such as Canada, Mexico, Brazil, Taiwan, and South Korea. Trade being multilateral, a depreciation against all currencies is not needed for a major reduction in the U.S. trade deficit. Nonetheless, a trade-weighted decline of 30 percent in the external value of the dollar, and of more than 20 percent in the International Monetary Fund's effective exchange rate, may or may not be sufficient to ensure a long-term trade balance.

Given all these lags in adjustment, the external value of the dollar has been able to fall under the impact of capital market forces, with little effect on the trade deficit. Capital inflows have remained high and the persistent trade deficit has provided the funds needed to finance them. Indeed, according to the mainstream view, as long as the net national dissavings associated with the budget deficit are not diminished, the capital inflow and the associated trade deficit have to continue and the value of the dollar will have to adjust. To illustrate, assume that the dollar were to stay at its low value long enough to begin to turn the trade deficit around. As long as net national dissavings remain unchanged, the dollar would be driven up once again to restore the trade deficit to the amount needed to finance the capital inflow.

Macroeconomic Policy Solutions

Unwinding Global Imbalances

The persistence of the U.S. trade deficit in the face of the substantial realignment of exchange rates that has occurred since early 1985 raises the question of whether exchange rate movements, even in conjunction with appropriate shifts in interest rates and other macroeconomic variables, will be sufficient to remove the trade deficit. Certainly, the concentration of trade and current account surpluses in Japan and West Germany and in a few smaller economies — notably Taiwan and the Netherlands — creates particular difficulties in unwinding the U.S. trade and current account deficits. Since the surpluses are concentrated in a few countries, which account for only about 35 percent of U.S. imports, significant narrowing of the U.S. trade deficit requires multilateral shifts in trade pat-

terns. Indeed, the uneven pattern of exchange rate movements since 1985 is suggestive of the tortuous adjustment in trade flows that needs to occur.

Two Scenarios

The empirical evidence, however, is strong that once the macroeconomic adjustments occur, movements in exchange rates — which are not offset by differential inflation rates — will result eventually in a restoration of greater balance in international trade and current accounts. (Of course, new shocks can always occur that will affect capital markets, causing new exchange rate disturbances.)

It seems probable that the U.S. economy will follow one or the other of two possible scenarios, or possibly some combination of the two.

Scenario 1: If the United States continues to make progress in reducing its domestic budget deficit in a manner roughly consistent with the Gramm-Rudman targets, its international payments will return gradually to a position of current account balance — or even tend toward current account surplus in the 1990s. Under this scenario, the turnaround in the U.S. trade account will be substantial, because achieving a current account balance in the early 1990s will require a significant trade surplus to service the U.S. economy's accumulated net foreign liabilities.

It is important to note that just because an adjustment mechanism exists, it does not have to operate smoothly and quickly. U.S. exports will need time to regain lost foreign markets even after a cost advantage is established. As a result, the exchange rate may overshoot its long-term value, encouraging capital flows that could become highly destabilizing. A full study would be needed to analyze all of the adjustment problems; our purpose here is simply to emphasize the existence and inevitable working of the adjustment mechanism. This is not to be taken as implying any underestimate on our part of the serious problems that undoubtedly will accompany the operation of this mechanism.

Scenario 2: If little further progress is made in reducing the U.S. domestic budget deficit, U.S. payments deficits on current account could be maintained into the 1990s, but mounting foreign liabilities would imply rising debt service payments. Eventually, the growing deficit on invisible account would match the surplus on capital account — meaning that the servicing of old debt and equity would equal new capital inflows. From that time on, the trade account would have to go into surplus, otherwise the United States would not be able to service all of its foreign-owned debt and equity. Under this scenario, the turnaround in the U.S. trade position would come more slowly. With a capital inflow that persisted at a level of U.S.$100 billion a year, servicing costs on existing foreign capital in the United States would begin to exceed new borrowings sometime in the

first half of the 1990s, necessitating a trade surplus by that time.

There is an alternative version of this scenario that worries many observers in the financial community. Being unwilling or unable to tackle the deficit problem by tax and expenditure changes, the administration might resort to the printing press. The resulting inflation would raise the real tax burden, due to the nonindexing of most tax rates, while lowering real expenditures, due to the lag between price increases and the adjustment of nominal spending. While inflation would not necessarily provide a permanent solution, it would reduce both the budget deficit and the trade deficit for some considerable time. It is not within the scope of this study to analyze the serious harm that this solution would cause. What matters for our analysis is only the following point. An unexpected inflation would reduce the real value of the United States' foreign liabilities — where they are dollar-denominated debt — by the amount of the unexpected inflation over the term of the debt. Although this would not be an insignificant reduction, the great bulk of the United States' foreign obligations would remain, so that a substantial trade surplus would still be required in the 1990s to service the remaining debt.

Conclusion

The stance of macroeconomic policy in the United States and other major developed countries will influence the evolution of the U.S. trade and current account balances. But even if the United States persists with a capital account surplus on the order of about U.S.$100 billion a year, there will have to be a substantial swing in the U.S. trade account in the 1990s. The necessity of servicing its international indebtedness will oblige the United States to achieve a surplus on current trade in goods and services, and the discipline of financial markets will impose the combination of exchange rates and interest rates necessary to ensure that this occurs.

Americans can learn from the Canadian experience (discussed in more detail in Box 3). During the 1970s, Canada pursued expansionary fiscal policies and ran a large current account deficit relative to the size of its GNP. As a result, Canada substantially increased its net foreign indebtedness. Today, Canada's foreign debt amounts to about 33 percent of its GNP, and it is running a substantial surplus in merchandise trade along with a substantial deficit in current account.

In the 1990s, the United States will face the same imperative to service its international obligations that Canada does today, but the debt imperative only constrains the shift in the trade account *balance*. The necessary contraction in the U.S. trade deficit could be achieved by an expansion of exports, a contraction of imports, or various combinations of the two. The balance between export expansion and import contraction will be

Box 3
Servicing International Liabilities: The Canadian Experience

Canada's experience with the exigencies of servicing international liabilities illustrates the pressures that will soon come into play for the U.S. economy. In the mid-1970s, Canada pursued an expansionary fiscal policy to offset the impact of the global recession that followed the first oil shock. Starting in 1975, after a decade during which the current account balance had fluctuated between small deficits and small surpluses, Canada began to run current account deficits averaging in excess of 2 percent of GNP through to the end of 1979.

Although Canada's current account deficit — expressed as a proportion of GNP — in the late 1970s was less than the current account deficit of the U.S. economy during the mid-1980s, Canada experienced a significant swing in its international balance sheet. At the end of 1974, Canada's net international liabilities — both debt and equity — amounted to 21 percent of GNP. By 1980, Canada's net international liabilities tripled in absolute terms and amounted to 33 percent of GNP. (It is worth noting that 70 percent of Canada's net international liabilities are held by U.S. residents.)

As a result of the shift in Canada's international balance sheet during the 1970s, the Canadian economy now must run substantial merchandise trade surpluses to service its international liabilities. During 1986, for example, Canada had a merchandise trade surplus of Can.$10 billion in order to help finance a deficit of Can.$3.5 billion in traded services and a deficit of Can.$16.8 billion in investment income. Without taking account of retained earnings of multinational firms, Canada had a current account deficit of Can.$8.8 billion, or almost 2 percent of GNP, in 1986.

influenced by policy and has important implications for U.S. and world economic welfare.

Policy Coordination: The Elusive Goal

Since the Plaza Agreement in September 1985, the major developed countries have made repeated efforts to achieve more coordinated macroeconomic policies to facilitate unwinding global current account imbalances. Initially, the focus was on exchange rates, but the significance of changing underlying fiscal and monetary policies has since been recognized. The 1986 Tokyo Summit declaration quite properly focused on the indicators of economic performance and on the stance of monetary and fiscal policy in the major developed countries. So far, the results of these efforts can be judged, at best, as mixed.

Two Scenarios

Once again, it is possible to construct two broad scenarios — one more benign, the other less so.

The Benign Scenario: The key elements of a benign scenario would involve the following:

- accommodative monetary policies and modest fiscal stimulus consistent with opportunities for sustainable noninflationary growth in those countries with trade surpluses — notably, Japan, West Germany, and the Netherlands;
- continued steady progress toward reducing budget deficits in the United States and Canada; and
- a combination of increased official development assistance and structural reforms in the developing countries to encourage direct investment, debt/equity swaps, and some repatriation of flight capital.

This combination of policies would facilitate an orderly reversal of existing global imbalances through an orderly realignment of exchange rates, and it would sustain the trend to lower real interest rates. The adjustment road may still be rocky but it will be a lot less so than under the alternative scenario considered below.

The Dismal Scenario: A much more dismal and hazardous scenario would involve the following:

- reluctance by countries with trade surpluses to pursue accommodative macroeconomic policies that would facilitate expansion of domestic demand;
- little further progress toward reducing government budget deficits in the United States and Canada; and
- lack of progress in facilitating a blend of public and private capital flows to indebted developing countries.

Under this scenario, all of the burden of reversing trade imbalances would fall on exchange markets, with the risk that world trade would stagnate. Both trade surplus and trade deficit countries would experience recessions. Those with surpluses would find exports falling as a result of exchange rate appreciation. Those with deficits would suffer from either or both of two contractionary influences. First, monetary and fiscal policy might be-

come more restrictive in an attempt to deal with trade deficits by the expenditure-reducing route that countries with deficits so commonly employed in the 1950s and 1960s. Second, some combination of exchange rate and inflationary concerns might lead foreign investors to demand much higher interest premiums before they were willing to absorb the necessary quantities of new U.S. assets into their portfolios. The resulting rise in interest rates would choke off domestic investment expenditure, thus causing a fall in economic activity.

This would be similar to what happened in Canada in 1982. As a result of the contraction of domestic consumption and investment spending associated with tight monetary policies, there was a fall in income and employment, which induced a fall in imports and an improvement in the trade balance (and, to a lesser extent, in the current account balance).

During the Bretton Woods years of fixed exchange rates, contracting the domestic economy was the main means of balancing external accounts for countries with trade deficits. If such countries were to pursue contractionary policies while those with surpluses experience recessions due to exchange rate appreciation and sagging exports, trade imbalances would be alleviated but at the cost of falling world trade and rising unemployment.

Conclusion

Under the benign scenario, there would be steady growth in world trade and faster elimination of excess capacity. The needed realignments of international trade flows would occur with relatively little dislocation, and protectionist pressures would be reduced. Under the dismal scenario, world trade would grow slowly and irregularly, excess capacity would persist in many industries, and the reversal of trade imbalances would be more difficult. The slow growth of trade would increase pressures for managed trade, and the resulting trade inhibitions could lead to a downward spiral of deepening protectionism and recession. Thus, the stance of macroeconomic policy greatly influences the prospects for world trade and the conduct of trade policy. (In contrast, many people taking part in the current U.S. debate assume that trade policy should be the primary vehicle used to reduce global imbalances.)

Trade Policy Solutions

Background

From the U.S. point of view, there is reason for frustration with the development of the trade liberalization movement. As many U.S. policymakers see it, the United States' reduction of its trade barriers since the Second World War has made it one of the world's most open econo-

mies with respect to trade in manufactured goods. It accepted the fact that other countries could not follow suit at first because of postwar balance of payments problems. Later, when tariffs were reduced multilaterally, the United States felt that other countries had retained many unfair advantages due to their greater use of such measures as nontariff barriers and subsidies. Many U.S. firms that sell goods in competition with foreign firms now see themselves as victims of the U.S. commitment to free enterprise — forced to compete on unequal terms with foreign firms that have access to the bottomless wells of national treasuries.

Similar perceptions exist with services. Many Americans perceive that every time they break into some new area of trade in services, foreign governments and firms produce new nontariff barriers that inhibit penetration of the market.

Agriculture presents a more complex case. U.S. postwar agricultural policy was highly interventionist and protectionist at first. Starting in the mid-1960s, it began to change. Domestic policy began to rely more on market forces, and U.S. agricultural policy became less protectionist as U.S. agriculture enjoyed increasing success in the export market. At the same time, the longer-term effects of the European Community's common agricultural policy (CAP) were becoming increasingly evident. Americans now see the CAP as working exactly against the forces of comparative advantage to make the European Community, which, by all economic forces, should be a major importer of agricultural goods, into a net exporter.

As far as agriculture and services are concerned, it is a case of past U.S. policies coming home to roost. We have already observed that the United States was responsible for the failure of the International Trade Organization (ITO) in the 1940s and that it played a large part in the removal of agriculture from effective application of the rules of the General Agreements on Tariffs and Trade (GATT) in the 1950s. Both of these stands were designed to prevent constraints being placed on U.S. domestic policies. Both came home to haunt the United States in the 1970s and 1980s. U.S. agriculture found itself suffering from competition resulting from European subsidy practices that likely would have been restricted by GATT rules if agriculture had not been excluded. U.S. service companies and multinationals now suffer from the lack of any international rules governing services trade and investment policies that might have been developed through the ITO.

Significant pressures are growing in Congress to look for trade account solutions to the trade account deficit, thus embracing the supply-side view outlined earlier. Many schemes are currently being mooted. Some are so extreme as to seek to impose something close to bilateral balances on each country that trades with the United States. More or less extreme, however, they all suffer from a failure to accept that the current account deficit cannot be removed until the capital account surplus is removed. Say, for

example, that a universal 10 percent surcharge were placed on all imports, while federal spending and tax rates remained unchanged. The effect would be to reduce the trade deficit, but the reduction in the supply of U.S. dollars on the foreign exchange market — due to the reduction of U.S. imports — would cause the dollar to appreciate until the current account deficit was restored. There would be some alleviation due to the extra revenues raised by the tariff — which would reduce the deficit and, hence, the need for capital imports — but the effect would be small.

We cannot yet foretell the outcome of the current U.S. legislative debate on the trade problem. In the meantime, the attack on the trade deficit is two-pronged. The first consists of the use of fair trade laws to penalize foreign governments that do not liberalize their trade. The second is the use of free trade negotiations to pressure nonparticipants into liberalizing trade. Below, we consider each of these in some detail.

Those who hold the supply-side view look primarily to trade policy solutions. Although mainstream economists hold that the solution to trade and current account imbalances lies in altering macroeconomic variables, they realize that trade policy is important. Those who support the trade-liberalizing movement are inclined to oppose the use of trade laws to solve the deficit on the grounds that trade laws are ineffective and can produce harmful side effects. They do not feel the same way about the use of free trade areas and other aggressive trade policies to put pressure for trade liberalization on other governments; such tactics may not solve the trade deficit but at least their side effects are beneficial.

Reliance on Fair Trade Laws

Not suprisingly, those who search for trade account solutions to trade account problems have fallen back on fair trade laws — in particular, on countervailing duties. In part, these substitute for effective, internationally agreed codes on subsidies and other export-promoting policies.

World Impact

The result of this approach has been the imposition of a *unilateral* U.S. definition of what is unfair, instead of the application of an international standard and the use of an international mechanism in settling disputes. Firms and governments that must cope with U.S. interpretation, and reinterpretation, of the rules of fair trade feel an understandable sense of frustration at not having agreed rules against which to plan their export strategies.

Not the least of the reasons for this frustration is the fact that U.S. fair trade laws are one-eyed judges. They look at foreign transgressions without making any attempt to compare them with similar domestic transgres-

sions. Although Canada's fair trade laws have evolved along similar lines and do not make allowances for the effects of domestic subsidies either, they do not have the economic impact on the United States that U.S. laws have on Canada.

To foreign exporters, the United States appears as a country that believes it is without sin, so that absolute levels of foreign sin also set levels of sin relative to the United States. (Canadians, of course, are never self-righteous.) A more reasonable view is that everyone sins and that punishment should be based on relative levels of sinfulness — in the case of countervail, on the net differences between the subsidies in the countries in question.

The unanimous resolution passed by the U.S. Senate in April 1987 condemning Canada's countervailing duty on imports of U.S. corn is a case in point. To Canadians, the duty is at least as justified as the U.S. countervailing duty on Canadian hogs and pork. But Americans tend to see this first-ever use of the countervail tool against the United States as an outrageously hostile act.

As U.S. policymakers look inward and become more protectionist, the whole carefully woven fabric of international trading relations — largely created by U.S. craftsmen — is at risk. Can the current thrust of U.S. policy be in the United States' own self-interest?

Once again, the United States seems to be in danger of adopting an expedient that, at best, will deal with a transitory current problem but come back to haunt its policymakers in the decades to follow. In the Canadian softwood lumber case, the United States argued that discretionary administration of public resource management schemes creates grounds for countervail. By doing so, it may have opened a Pandora's box. U.S. farmers who benefit from the use of water rights from public rivers and government-assisted irrigation schemes could face countervail from foreign countries.

The precedent set by the 1986 softwood lumber decision and the changes in U.S. countervail laws proposed in the House go beyond resource industries to regard any government regulation that involves an element of discretionary administration as creating the basis for a subsidy. This effort to attack any discretion in the administration of such government regulations as antitrust laws or environmental standards creates a precedent that could cause serious problems for U.S. export firms in the future. For example, the treatment of U.S. chemical companies under U.S. environmental protection laws could also be countervailable, as could the output of any firm receiving state industrial development bonds or local government assistance with land development. So also could high-technology industries that secure government contracts on the basis of decisions involving discretion rather than the blind application of rigid rules.

Impact on Canada

There are many reasons why Canadians express growing concern over the evolving use of U.S. countervail and other fair trade laws.

First, since the Canadian market is only about one-tenth the size of the U.S. market, the threat of U.S. countervail is much more serious for Canadian-based firms serving the two countries' combined market than is the threat of Canadian countervail to U.S.-based firms serving the same market. A firm serving the combined market from a Canadian location is likely to have a much higher proportion of its sales accounted for by exports, and thus at risk to U.S. countervail, than would another firm serving the same market from a U.S. location, with its exports at risk to Canadian countervail.

Second, the United States' repeated unilateral reinterpretation of its fair trade laws means that no Canadian exporter can feel secure. A recent illustration of the power of these laws is the U.S. determination in 1986 that Canadian timber stumpage policies constitute a subsidy, justifying a large countervailing duty on Canadian exports of softwood lumber to the United States. This decision reversed, on what seems to be weak pretexts, an earlier ruling that such Canadian policies do not constitute a countervailable subsidy. It also reinforced Canadian views that there is nothing secure about access to the U.S. market. Canadians have come to suspect that whenever their market penetration upsets U.S. interests, some pretext for new countervailing duties will be found. Yesterday, it was pork and hogs and fish; today, it is softwood lumber and potash; tomorrow, will it be pulp and paper, autos, and transportation equipment?

Since more that 20 percent of Canada's GNP is directly produced by trade with the United States while only 2 percent of the United States' GNP is produced by trade with Canada, the United States can afford, in purely cost-benefit terms, to play tough with its small northern neighbor. But the precedents are serious. Countries that are in a position to hurt the United States may learn to copy these U.S. tactics and do considerable harm to world trading relations — the very relations that the United States has worked so hard to build up over the past few decades.

The third reason for Canadian concern is that the combined effect of the first two forces is a strong incentive for successful Canadian exporters to emigrate to the United States. Indeed, they are already doing so in numbers that are very worrying to Canadian authorities. Surveys of investment intentions show that this exodus is likely to grow substantially over the next five years.

Fourth, the target of U.S. countervail is shifting from specific, clearly trade-distorting subsidies to policies that are more general. Although legislative proposals to redefine subsidy have not yet become law, the U.S. Department of Commerce has altered its interpretation of trade laws in

what looks to foreign observers to be a response to political pressures and recent decisions in the Court of International Trade. We have already noted the softwood lumber case. But apart from the dangerous precedents it creates for foreign countries to inhibit the necessary elimination of the U.S. trade deficit through export growth in the 1990s, the episode raises some specifically Canadian concerns. In its preliminary decision of October 1986, the Department of Commerce reversed its earlier ruling made in 1983 that Canada's stumpage practices were not countervailable subsidies. This unilateral and sudden reversal of the department's previous stand meant that an agency of the U.S. government was passing judgment on long-standing resource tenure systems and stumpage policies of Canadian provinces. Canadians wonder if, in order to be allowed to trade with the United States, they will have to restructure their economic policies to duplicate U.S. policies exactly. The softwood lumber negotiations suggest that this worry may not be a mere exercise in fantasy.

One of the themes of our recent research has been that U.S. actions to redefine unilaterally what constitutes unfair trade exert great pressures on Canadian economic policy.[2] Certainly, the preliminary softwood lumber decision unleashed pressures on the Canadian federal and provincial governments, and on the Canadian lumber industry, that were extremely divisive. Moreover, as this case illustrates, our earlier concerns about the U.S. trend to broaden its definition of unfair trade have been regrettably prescient.

The changes to countervailing duty laws proposed in HR3 as passed by the House of Representatives seek to codify the preliminary decision by the Department of Commerce in the softwood lumber case by attacking a wide variety of industrial targeting practices. It is ironic that, beyond creating problems for Canadian resource policies, such a broadening of countervail laws would make it extremely difficult for Canada to pursue any of the policies proposed for the United States by the industrial policy school. For example, many in the United States support immunity for export cartels from antitrust laws, but a parallel policy by Canada would be attacked under U.S. countervailing duty laws.

In the precedent set by the softwood lumber case, many economists see a reincarnation of the doctrine of the scientific tariff, according to which, tariffs should be used to remove international differences in costs of production reflecting differences in comparative advantage. To nervous Canadian observers, the present U.S. position seems to be evolving toward using countervailing duties to remove international differences in resource management schemes, environmental control, and the administration of any regulations applying to specific sectors and allowing discretion to the

[2]See C.D. Howe Institute, *Policy Harmonization: The Effects of a Canadian-American Free Trade Area* (Toronto, 1986).

administrators. In this broadening of the scope of countervail, many Canadians see the current U.S. approach as a direct attack on their sovereignty.

Negotiations to Open Foreign Markets

A second string in the drive to liberalize trade stems solely from the Reagan administration. This is to use trade-liberalizing measures to induce foreigners to remove trading practices that Americans perceive as unfair. This option can be pursued through the recently launched Uruguay Round of GATT negotiations and through bilateral talks.

After the failure of the GATT ministerial conference in 1982 to reach agreement on the start of another round of GATT talks, the administration's interest shifted toward bilateral negotiations of free trade areas. This interest was stated in the February 1985 *Economic Report of the President:*

> the possibility of [free trade area]...negotiations offers the United States and others the option of using a free-trade instrument, rather than protectionism, as a lever against protectionist countries that are recalcitrant in fully multilateral negotiations.[3]

One such agreement, between the United States and Israel, has been completed, but the volume of trade involved is small.

A much more complex case arose in 1985 when the Canadian government, in what was an historic move for Canada, formally requested the opening of negotiations directed toward forming a Canadian-U.S. free trade area. As expected, a heated debate developed between Canadian nationalists, who fear U.S. encroachments on Canadian sovereignty and who advocate using trade restrictions to reduce Canadian dependence on the United States, and Canadian internationalists, who believe that Canadian economic prosperity will be increased by gaining free access to the U.S. market while its political independence will not thereby be diminished.[4]

Canadians worry that the growing tide of U.S. protectionist sentiment poses a threat to these historic negotiations. The threat could come in two ways. First, the U.S. negotiators may make unreasonable demands to which no Canadian government facing an election could accede, and they may also be unwilling to budge on key Canadian requests. Second, when the bill comes before Congress on the fast track process in late 1987, it could be rejected. Canadians worry that at this critical time, many Americans,

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[3]United States, Executive Office of the President, *Economic Report of the President, Transmitted to the Congress February 1985, together with the Annual Report of the Council of Economic Advisors* (Washington, D.C.: U.S. Government Printing Office, 1985), p. 126.

[4]For a discussion of these divergent views, see R.G. Lipsey, "Canada and the United States: The Economic Dimension," in C.E. Doran and J.H. Stigler, eds., *Canada and the United States: Enduring Friendship, Persistent Stress* (New York: Prentice Hall 1985); and R.G. Lipsey and M.G. Smith, *Taking the Initiative: Canada's Trade Options in a Turbulent World*, Observation 27 (Toronto: C.D. Howe Institute, 1985).

preoccupied by their trade deficit and by alleged unfair foreign trade practices, seem to have lost sight of what is at issue — or seem never to have known in the first place.

Although the overt approach was Canada's, many Americans do not realize how much the United States encouraged the possibility of opening free trade negotiations. The free trade route was, in fact, a far-sighted U.S. initiative in political economy. It was intended to send a signal to the world, not just to exploit some narrow gains with respect to Canadian-U.S. or Israeli-U.S. trade.

Too few in Congress seem to realize the historic proportions of Canada's willingness to open negotiations, when such a move has always been thought to spell certain political death for any Canadian government. This view had been accepted wisdom in Canada since 1911, when a Liberal government suffered a massive defeat in an election fought partly over its advocacy of a free trade agreement with the United States. Similarly, few in the United States realize the ferocity of the debate in Canada between the internationalists and the nationalists. Many Canadians believe that recent trade disputes, such as those on softwood lumber, steel, and potash, result from the bilateral negotiations and fail to recognize that those U.S. protectionist pressures would have operated with or without the trade talks. If the talks are perceived to fail through U.S. intransigence, a nationalist, anti-U.S. backlash could have serious implications for Canadian-U.S. relations over the next decade or more. Canada has its own problems, of course, and it is not inconceivable that Canadian difficulties, particularly in federal-provincial relations, could be responsible for failure to complete the agreement.

One wonders whether many in Congress realize how closely the rest of the world — the European Community, in particular — is watching these negotiations. If the United States is unable to reach a trade-liberalizing agreement with its closest friend and ally, and largest trading partner, the lessons that others will draw from the experience will bode ill for the next round of GATT negotiations.

The primary Canadian objective in the bilateral talks is to secure freedom of access for Canadian-based firms to the U.S. market — while offering the same access for U.S.-based firms to the Canadian market. From Canada's point of view, the removal of U.S. tariffs is not enough — the threat of continued unilateral U.S. reinterpretation of its fair trade laws is sufficient to prevent security of access and to provide the already mentioned incentive for successful Canadian export firms to move to the United States.

The United States' objectives, as well as wanting to show the world that there still is life in the trade liberalization movement, include getting some agreements on services and intellectual property that may be prototypes for GATT agreements, getting some agreement on the rules for treatment

of foreign investment, and gaining elimination of the higher Canadian tariffs.

It remains to be seen whether or not Congress will be willing to alter U.S. trade laws in either their substance or their applicability. Few Canadians would presume to ask that Canada be totally exempted from U.S. trade laws. Rather, what they want is for the United States to use its existing trade laws, and to develop new approaches to limiting unfair trade practices, in the spirit of U.S. rhetoric about creating a level playing field. In response to U.S. claims that it wishes to open up foreign markets, not close U.S. markets, Canadians would like to call the United States' bluff and suggest ways in which the trade rules could be redefined to level up the playing field — for example, by making countervail apply to the net difference between the two countries' subsidies, rather than to any gross Canadian subsidy, as is now the case. If Congress is unwilling to touch the fair trade laws or to constrain them to apply only to mutually agreed unfair practices, the talks are likely to fail. An historic opportunity will then have been lost, and the gap between U.S. rhetoric and U.S. behavior will become apparent to all.

Failure of the bilateral talks could well weaken the prospects of the United States' achieving its objectives in the Uruguay Round of GATT talks. If Canada and the United States cannot reach an agreement on rules to control nontariff barriers, open up trade in services, protect intellectual property, and clarify and liberalize investment policies, it will be difficult to make progress on these issues in the cumbersome multilateral forum.

In their current mood, some Americans may not attach a high priority to success in the GATT talks. For example, some of the proposed amendments granting negotiating authority for the Uruguay Round undermine the fast track procedure for implementing a trade agreement. Yet, other countries will not negotiate with the United States if Congress tampers with this procedure. Instead, these Americans appear to take a unilateral approach of broadening the application of U.S. fair trade laws. But such an approach will be much less effective in promoting U.S. objectives in the 1990s, when the United States will be obliged to run trade surpluses. The United States may then regret that it did not take the opportunity, starting with Canada, to develop effective *international* rules governing subsidies, dumping, and other unfair trade practices.

The United States may be correct in feeling that it has to take an aggressive posture regarding these practices if genuine progress is to be achieved in trade negotiations, but, as an alternative to adopting unilateral provisions under U.S. laws, it could follow a two-pronged strategy. First, it could negotiate a new set of international trade rules with Canada to deal with unfair trade issues. Second, it could pass the unilateral provisions in U.S. trade law directed at other countries but suspend their application for a period of, say, three years to give other countries the

opportunity to negotiate a new set of multilateral trade rules. This is the strategy that the United States pursued during the Tokyo Round, when the application of countervailing duty law was suspended pending the outcome of the negotiations. Success in both the bilateral and multilateral trade talks would ensure that dynamic U.S. industries have opportunities to expand their exports of high-technology goods and services — opportunities that will be vital to improving U.S. living standards in the 1990s.

Industrial Policy Solutions

Many in the industrial policy school blame the current U.S. trade deficit on a loss of U.S. competitiveness. In turn, this is thought to be due not merely to an overvalued dollar but to the failure of U.S. business and of U.S. public policy.

The longer-term challenges that the North American economy faces from foreign competition need to be examined and policy responses considered. We worry, for example, that the North American education system is failing to produce the middle-range skills needed to support a comparative advantage in many high-value-added lines of production in the next generation. We are prepared, therefore, to entertain hypotheses using such dramatic words as "crisis". We find it difficult, however, to blame the dramatic rise of the U.S. trade deficit over a few years in the 1980s, on the loss of the United States' competitive edge, which, after all, must be a slowly unfolding process. Yet, many in Washington predict a permanent trade deficit brought about by a permanent loss of U.S. competitiveness, unless public policy intervenes to change the trend.

The message that the United States is losing its competitiveness appeals to many who see decay besetting the whole of U.S. society. The message that the downslide can be reversed by active policies appeals to basic U.S. optimism. The message that what are needed are protection and subsidies appeals to employers and employees in industries hard pressed by foreign competition and to those politicians who depend on their votes. The irreversibilities that the new analysis of industrial organization emphasizes make this worry particularly appealing — even a temporary loss of competitiveness due to a temporarily overvalued dollar may be translated into a competitive disadvantage that persists long after the dollar has returned to its purchasing power parity rate. But the new analysis of industrial organization does not necessarily provide a rationale for the kinds of relief from import competition sought by those in the trenches.

We do not see evidence of error in the mainstream economists' view that the U.S. trade deficit is transitory, *even if* the relative decline in U.S. productivity and living standards should prove permanent. If this explanation is correct, the 1990s will see the disappearance of Americans' fear that they have suddenly lost their ability to compete sufficiently to achieve

a balance of payments on trade account, because the need to service foreign capital in the United States will force a U.S. trade surplus into being. The permanent problem of the trade deficit, induced by competitive failure, will then join the list of other, now-forgotten "permanent" problems.

It does not follow from this, however, that the United States has no long-term competitiveness problem similar to the one that turned the United Kingdom from the country with the second-highest per capita GNP in Europe (second to Luxembourg) in 1955 to one with a standing below that of every country in the European Community with the exception of Greece, Spain, and Portugal. This possibility needs to be debated and appropriate solutions discussed. But if sensible policies are to be considered, the long-term issue must be separated from the quite separate, short-term competitiveness phenomenon: the inability of U.S. exports to match U.S. imports under present conditions, when large capital imports, brought about by net U.S. dissavings, make a trade deficit inevitable.

Clearly, Canada and the United States face an increasingly competitive world economy. The pressures for adjustment come from technological competition among high-income economies, from the emergence of the newly industrializing countries in heavy industries, and from export-oriented developing countries in light manufacturing. But these are long-term challenges, which need to be analyzed carefully before policy changes are proposed and implemented. The atmosphere of crisis engendered by the concern about the U.S. trade deficit threatens to result in precipitous policy actions that could have unfortunate long-term consequences.

Although much more research is needed on the longer-term problem, there is some agreement right now on certain broad domestic policies that will promote productivity growth and enhance the long-term competitive position of the U.S. economy. The key points of agreement likely would include:

- government tax and spending policies that reduce budget deficits and increase private savings;
- policies that improve the quality of, and increase investment in, education;
- policies that protect intellectual property rights, to promote investment in technology;
- labor market policies, including assistance for retraining, that promote economic adjustment; and
- removing those regulatory policies that inhibit economic adjustment.

Many of these domestic policy proposals would be of equal value for both Canada and the United States. Efforts by either country to adjust domestic

policies in these directions will have beneficial indirect effects on the other country but little effect one way or the other on their trade balance.

More contentious recommendations concern interventionist policies such as identifying, and spending government money on, emerging firms and industries that will be sources of future economic growth.

Conclusion

Mainstream economics has much to contribute to the current debate about U.S. trade policy and the competitiveness problem. Here are some of the major points that should be considered.

- In the January 12, 1987, issue of *Newsweek*, the magazine's chief economics correspondent, having spoken of the latest measures being mooted in Congress as being "the least harmful policy" and "maybe about the last idea left," referred to the "knee-jerk reactions from free traders." You do not have to be a "knee-jerk free trader" to realize that although the measures currently before Congress may be the last ideas left, the public seems to have forgotten that the "first idea" — the one that has been in all the textbooks for many years — has not even been tried. If the domestic budget deficit is cut to reduce net national dissavings substantially, the need for capital imports will fall drastically; if capital imports fall, the resulting adjustments in interest rates and exchange rates will reduce the trade deficit. Although progress in coordinating economic policies among the developed countries will help to ensure that growth in global trade and economic activity is sustained, it must be recognized that the principal policy change required — reduction of the U.S. budget deficit — lies wholly within the power of the U.S. Congress.

- Although there are serious cases of unfair trading practices in many countries, including some in the United States, these are not the major cause of the U.S. trade deficit. The United States should resist the temptation to take part in the erosion of the carefully constructed regime of liberalized trade by encouraging trade wars and by making its own unilateral redefinitions of the rules of fair trade. Decisions currently being taken on the application of fair trade laws — particularly in the Canadian softwood lumber case — may be setting precedents that will come back to haunt the United States in the 1990s, when other countries begin to employ similar measures to reduce U.S. exports. Proposed legislation seeks to amend the antidumping and countervailing duty laws, as well as the escape clause provision. These amendments are designed to make import relief more accessible and more automatic for U.S. producers, as well to make retaliation against unfair foreign practices mandatory in some circumstances. This approach appeals to many in Congress as a quick fix

for the problems of the trade deficit, but it will be self-defeating in the long term.

• Since the trade deficit will fall to manageable proportions once net national dissavings fall, and since enormous U.S. foreign liabilities will have to be serviced, necessitating a trade surplus by the mid-1990s, the United States has a long-term interest in preserving the now-threatened structure of liberalized world trade. Economists, whose profession should equip them to look beyond today's current pressing problems, have an obligation to emphasize to policymakers the hazards of the present tendency of U.S. policies to be guided by short-term considerations.

• Pressure needs to be put on reluctant foreign governments to liberalize trade and to reduce unfair trading practices. This is better achieved, however, by bilateral free trade agreements and by multilateral negotiations that raise U.S. living standards and reduce the average level of world trade restrictions than by trade wars that lower U.S. living standards and increase average trade restrictions. The free trade negotiations with Canada should be regarded, therefore, as a far-reaching exercise in political economy, rather than judged on the narrow cost-benefit calculus of bilateral gains and losses due to trade creation and trade diversion. Unilateral measures to alter U.S. trade laws are likely to be counterproductive to efforts to negotiate trade liberalization, either bilaterally or multilaterally. As an alternative to the proposed changes to U.S. trade laws, Congress could follow the example of the *Trade Act of 1974*, which suspended the use of countervailing duties pending the outcome of the Tokyo Round of GATT negotiations. In the current case, new trade legislation should await the outcome of negotiations on a Canadian-U.S. free trade area and those involving the Uruguay Round of the GATT.

• Finally, there may well be a long-term problem with U.S. competitiveness, but it has little or nothing to do with the sudden loss of competitiveness that has produced the trade deficit of the 1980s. That sudden loss was due to the high value of the U.S. dollar made necessary by the large volume of capital imports into the United States. Any long-term competitiveness problem is likely to manifest itself in declines in U.S. living standards relative to those in other countries, but *not* in a permanent trade deficit. After all, the United Kingdom has gone from a major to a minor industrial power, with a consequent enormous fall in relative living standards, without developing a persistent balance of payments problem. The competitiveness problem needs urgent study with a view to developing appropriate remedies where they are needed. But, should they be found

necessary, the appropriate solutions will lie in domestic policies to increase competitiveness, not in external policies to limit international competition by restrictions on trade.

It is not yet too late for the developed countries to adopt the coordinated macroeconomic policies that will help unwind global trade imbalances and sustain growth in the world economy. Furthermore, Congress may well avoid passing the more extreme protectionist trade proposals and enact a "moderate" trade bill that rewrites U.S. fair trade laws. The world economy may avoid falling off the edge of a precipice, but the resulting changes in U.S. trade laws could still have serious implications for all countries that trade with the United States, and set serious precedents for the behavior of other countries in the 1990s.

Unilateral U.S. or Canadian measures under trade laws can be useful where they serve to discourage genuinely unfair trade practices, although even here a multilateral solution would be preferable. Tightening the trade laws where they are used as trade barriers and where they encourage rounds of competitive retaliation is counterproductive, however, and threatens a case-by-case slide into a world of Smoot-Hawley-type trade restrictions, which, in turn, could cause a spiral of debt default and global recession.

The outcome of the current trade policy debate in the United States remains uncertain, but even the more moderate outcomes will have important and potentially damaging consequences for Canadian-U.S. economic relations. With a few minor exceptions, all changes to U.S. trade laws have made them more stringent by broadening their application against real or imagined unfair trade practices and by making it easier for U.S. producers to obtain relief. Even a moderate trade bill will increase significantly the stringency of these laws and, as the largest exporter to the United States, Canada will be the biggest loser from these changes. If the United States continues to reinforce its arsenal of trade laws, tension and conflict in bilateral economic relations will increase. But if the United States stresses efforts to negotiate the opening up of foreign markets and to strengthen the domestic economy, both countries stand to share the mutual benefits of greater cooperation.

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